Economic Trends

This month's Economic Trends is taken from the Economic Outlook chapter of Budget 2018: A recovery built to last, released on March 22, 2018.

Economy Enters Second Year of Recovery

The rebound in Alberta's economy surpassed expectations in 2017. Real GDP grew an estimated 4.5% following a deep two-year recession. The resurgence was broad-based, with nearly every sector expanding.

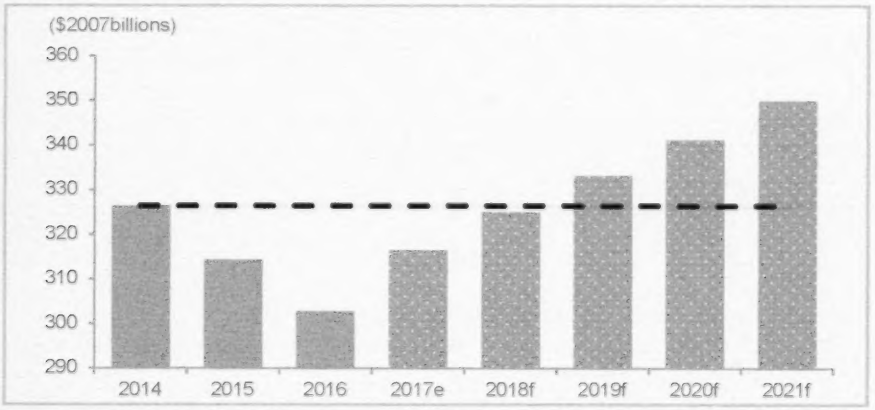
Building off the surge in activity in 2017, the economy is forecast to expand at a solid rate of 2.7% in 2018. Exports will continue to drive growth, as oil sands output ramps up and production begins at the Sturgeon Refinery. The substantial improvement in the labour market at the end of 2017 is expected to carry through into the new year and boost housing and consumer spending. However, the recovery in business investment will lag the broader economic recovery due to the lingering impacts of the oil price shock.

As the economy moves from recovery into expansion (Chart 1), growth will be driven less by exports and more by investment. Non-residential investment will start to pick up in 2019. Until pipelines are built, market access challenges are likely to restrain upstream oil and gas investment. However, downstream investment in petrochemical facilities and partial upgraders will help support real GDP growth of around 2.5% from 2019 to 2021. Households, too, will contribute to the expansion, with spending supported by rising incomes and solid population growth of about 1.5% per year.

Global Economy

The global economy exceeded expectations in 2017 as it rose at its fastest pace since 2011. A concerted rebound in global trade, business investment and industrial production paved the way for a synchronized expansion across countries for the first time following the 2009 global financial crisis. Global growth is forecast to accelerate to 3.7% in 2018 and 2019 from an estimated 3.6% in 2017. A sustained global expansion will support prices and improve prospects for the Alberta economy, given the province's high reliance on trade and commodities.

Chart 1: Economy moves from recovery to expansion
Alberta Real GDP



Sources: Statistics Canada and Alberta Treasury Board and Finance, e-estimate, f-forecast

Synchronized growth to continue

Growth prospects for advanced economies have improved markedly over the past year. While activity accelerated significantly in most advanced economies, the upturn was pronounced in the Euro Area. Real GDP grew an estimated 2.5% in 2017, the best performance in over a decade. Growth in the region is forecast to proceed at around 2% in 2018 and 2019. In the US, a broad-based upswing in business investment, led by the energy sector, contributed to further strengthening in the labour market. Real GDP growth is forecast to accelerate to around 2.5% in 2018 and 2019 before slowing to around 2% thereafter.

Growth in emerging markets is also projected to strengthen in the near term. Firmer commodity prices are fuelling the recovery in resource-exporting countries such as Brazil and Russia. Although growth in China's economy is anticipated to slow from an estimated 6.8% in 2017 to 6.2% by 2021, it has been revised up from previous forecasts.

Interest rates rising gradually

In the aftermath of the 2009 global financial crisis, central banks in advanced economies implemented extraordinary measures to support economic growth, such as exceptionally low policy interest rates and quantitative easing programs. With growth on a solid footing and labour markets finally showing signs of tightening in several advanced economies, monetary policy is shifting. Central banks in the US, Canada and England have all raised rates in the last year, while in the European Central bank has started scaling back its stimulative bond-buying program. Even as interest rates rise at a gradual pace, monetary policy is expected to be highly accommodative and supportive of growth, as interest rates in most of these countries remain near historic lows.

Modest improvement in oil prices

The global oil market is rebalancing against a backdrop of supply restraint and accelerating economic growth. Global oil demand has benefitted from

a broad-based expansion in industrial activity in 2017. An agreement by the Organization of the Petroleum Exporting Countries (OPEC) and several non-OPEC producers to extend output cuts until the end of this year, combined with strong compliance with the agreement, has helped reduce the supply glut.

The US, however, remains a key driver of global supply growth. US production has been rising steadily since late 2016, and in late 2017 reached a record high. With US shale oil producers very responsive to higher prices, expanding production is expected to keep a lid on price growth this year. West Texas Intermediate (WTI), the North American benchmark oil price, is forecast to average US$59/bbl in 2018-19. Over the medium term, the oil market is expected to be well supplied, given ample low-cost OPEC output and strong gains in non-OPEC production, led by US shale. WTI is forecast to rise to US$63/ bbl by 2020-21, which is still well below the levels prior to the downturn (Chart 2).

Canadian Economy

Following lacklustre growth in 2016, the Canadian economy grew at an exceptionally strong pace in the first half of 2017. This was largely driven by a rebound in Alberta's economy. Momentum slowed in the second half of the year as growth in Alberta moderated, particularly in the oil and gas sector (Chart 3). Even so, the Canadian economy led growth among G7 economies, at 3.0%.

Real GDP growth is forecast to moderate to a still solid pace of 2.2% in 2018 and 2.0% in 2019 before averaging around 1.8% over the medium term. Consumer spending is expected to contribute to growth, underpinned by strong job gains and improving wage growth. Meanwhile, higher interest rates, elevated household debt and changes to housing policy are likely to cool down residential activity. Firmer oil prices, strong global growth and industrial capacity pressures in the US and Canada are anticipated to bolster business investment and exports, although uncertainty surrounding the NAFTA negotiations is weighing on the near-term outlook. The Loonie is forecast to appreciate gradually from US¢78/Cdn$ in 2017-18 to US¢80/Cdn$ in 2019-20.

Alberta Economy

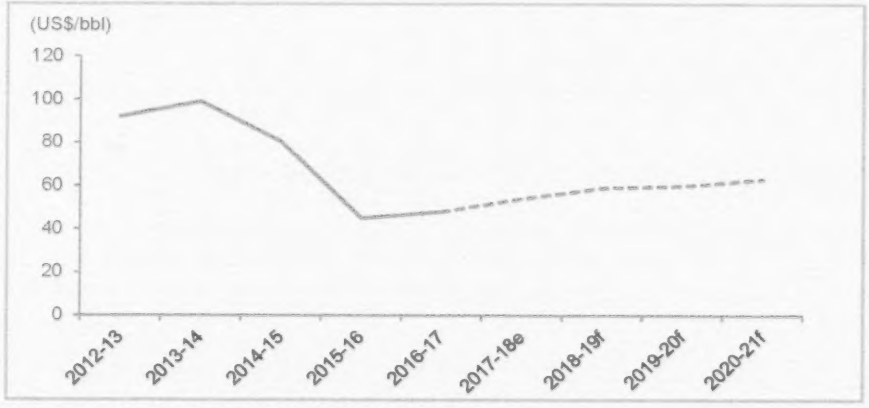
The Alberta economy will move closer to a full recovery in 2018, building off the strong broad-based rebound in 2017. Real GDP growth is forecast to be 2.7%, driven by rising exports and strong consumer spending. Beyond 2018, the Alberta economy is set to shift into expansion mode at a solid pace of around 2.5%, consistent with robust population growth, an upturn in investment and a broadening of economic activity.

Transition from recovery to expansion

The Alberta economy is well on its way to fully recovering from one of the worst recessions of the last 40 years. However, given the depth of the downturn, the recovery has been drawn out. The economy is not expected to move into expansion until 2019, when the level of economic output (measured by real GDP) surpasses pre-recession levels. The unemployment rate remains elevated as people continue to enter the labour force and is not forecast to move near pre-recession rates until 2021.

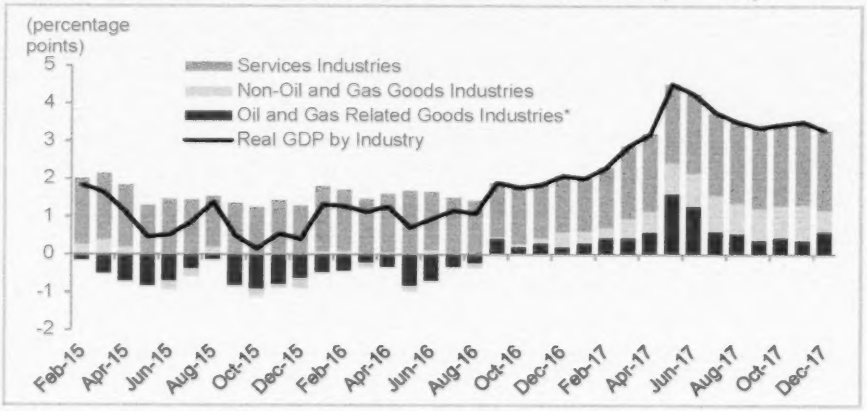
Exports will continue to propel growth during the recovery as oil production rises and manufacturing capacity expands. Real exports are forecast to increase almost 5% in 2018 and around 3% between 2019 and 2021. As the pace of production moderates,

Chart 2: Muted outlook for oil prices
West Texas Intermediate



Source: Alberta Energy, e-estimate, f-forecast

Chart 3: Energy sector lifts Canadian growth in 2017
Contribution to Year-Over-Year Change in Canadian Real GDP by Industry



Sources: Statistics Canada and Alberta Treasury Board and Finance
* Oil and gas extraction, support services for mining, oil and gas and engineering construction.

growth will be driven more by investment. Business investment, which has lagged the rest of the recovery, is expected to turn around starting in 2019. Although the outlook for oil and gas investment is muted, investment in non-residential construction, in particular manufacturing, is expected to help fuel the economic expansion.

Oil production drives exports

With several large oil sands projects finishing construction and ramping up, oil production is set to grow significantly (Chart 4). In 2018, production is forecast to increase more than 360,000 barrels per day (bpd), following an increase of almost 300,000 bpd in 2017. Another 380,000 bpd of production is expected to be added from 2019 to 2021, when a number of in situ expansion projects become operational. This will bring Alberta oil production to just under four million bpd and maintain Canada's position as one of the world's largest oil producers.

Alberta's manufacturing base continues to expand

Exports will be further supported by capacity expansions in Alberta's manufacturing sector which will add value to Alberta's resources and boost growth across several sectors of the economy. Following an estimated increase of over 7% in 2017, real manufacturing exports are expected to increase close to 4% in 2018. Petroleum manufacturing will be boosted by the Sturgeon Refinery, Canada's first new refinery in over 30 years. Production at the facility will ramp up throughout the year, eventually reaching its 80,000 bpd capacity. Petrochemical capacity expansions through the province's Petrochemical Diversification Program (PDP) are expected to come online by 2021. Food manufacturing will increase in 2019 with completion of the $360-million Cavendish Farms potato processing plant in Lethbridge. These projects will keep real manufacturing exports growing at 3.3% on average between 2019 and 2021.

Agriculture and forestry remain steady

Alberta's agriculture and forestry industries are expected to see solid growth in 2018 following a strong expansion in 2017. Despite some regionally adverse weather, overall improved growing conditions led to strong production of wheat and canola last year. This is expected to boost Alberta's crop exports. Livestock and meat demand is likely to see moderate growth, supported by growing global demand for quality protein options.

In the forestry sector, lumber producers will continue to benefit from elevated prices. Tight supply and strong demand in the US have so far enabled Canadian producers to pass softwood lumber duties onto US consumers.

While ongoing uncertainty in the NAFTA renegotiations poses significant risks to the outlook for the agriculture and forestry sectors, other trade agreements are set to create new business opportunities. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) signed in March 2018 may take effect as early as the end of 2018 and enhance access to Asian markets.

Wider differential weighs on oil sands investment

Although WTI prices are forecast to improve gradually over the forecast period, Alberta producers will not be able to fully realize the gains. This is mainly due to ongoing pipeline bottlenecks. The WTI-WCS differential is forecast to increase from around US$14.50/ bbl in 2017-18 to over US$20/bbl in 2018-19. Two pipelines, the Enbridge Line 3 replacement and Trans Mountain Expansion (TMX), will alleviate bottlenecks in 2020 and 2021. However, the light-heavy differential is forecast to remain wide as new International Maritime Organization sulphur content rules for marine fuels go into effect. This is expected to reduce demand for bunker fuel, which mainly comes from heavy oil, and reduce heavy oil prices.

The wider differential will weigh on oil sands investment, which is forecast to fall 10% in 2018 and recover moderately over the remainder of the forecast period. The decline in 2018 is largely driven by a reduction in spending following the completion of the Fort Hills oil sands mine and the Horizon Phase 3 expansion in 2017. Companies continue to focus on containing costs, which allowed operators to reduce sustaining capital outlays in 2017. However, sustaining capital requirements in 2018 and throughout the forecast period are expected to increase along with oil production. Investment will also be boosted by thermal expansion projects, which will add around 250,000 bpd of capacity between 2019 and 2021.

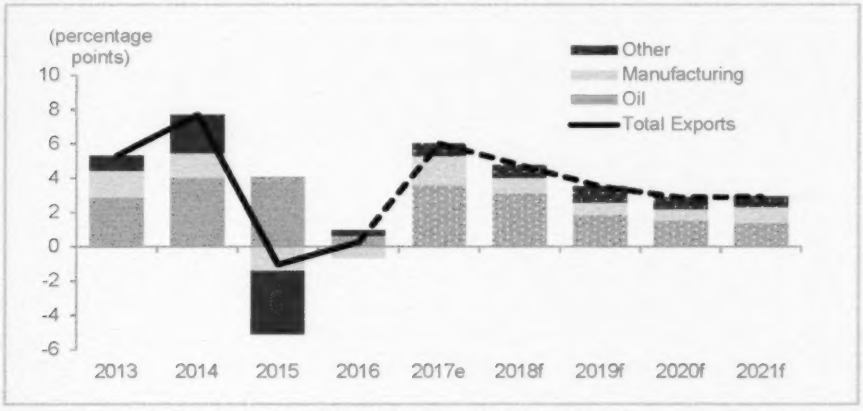
Natural gas surplus slowly unwinds

North America continues to be awash in natural gas. Alberta drillers are increasingly targeting natural gas liquids-rich deposits, mainly to feed demand for condensate used to dilute bitumen for pipeline transportation. Condensate, being priced closer to WTI, fetches a higher price than natural gas. Production has more than doubled since 2016.

Demand for natural gas in Alberta is expected to rise over the next several years due to expanding oil sands operations, the continued transition to gas power generation and the expanding petrochemical industry in Alberta.

Chart 4: Strong growth in oil production

Contribution to Change in Alberta Real Exports



Source: Alberta Treasury Board and Finance, e-estimate, f-forecast

In addition, two new propane terminals in BC will boost demand for propane. However, imports are expected to rise as TransCanada Pipeline expands its Nova Gas Transmission System connecting BC gas to Alberta. Natural gas prices in Alberta will only improve modestly. The Alberta reference price for natural gas is forecast to rise gradually from $2.00 in 2018-19 to $2.40 in 2020-21.

Conventional oil and gas drives energy investment

The conventional oil and gas sector is seeing a resurgence in activity. In 2017, investment is estimated to have increased almost 60% as producers responded to higher oil prices by increasing drilling. Despite low natural gas prices, Alberta liquids-rich plays remain competitive compared with other areas in North America because of low drilling costs and proximity to the condensate market. Alberta's emerging crude oil plays are becoming more understood and offer fast returns. Increased interest in conventional oil and gas activity resulted in $505 million worth of Crown land sales in 2017, more than triple 2016 sales. Rising prices for condensate and light oil will support conventional oil and gas investment, which is forecast to expand nearly 6% this year. Between 2019 and 2021, investment is forecast to grow an average of 4.6% annually and overtake oil sands investment (Chart 5).

Non-residential construction recovers with a lag

Non-residential construction is expected to edge lower in 2018 before gradually picking up. Commercial and industrial construction continues to be weighed down by elevated commercial real estate vacancies and the pullback in oil sands investment. A bright spot, however, is the manufacturing sector. According to Statistics Canada's Survey of Investment Intentions, manufacturing investment is set to increase by almost $800 million this year (Chart 6). Overall, non-residential investment is expected to decline 1.9% in 2018 before rebounding 2.5% in 2019. Growth rises to 5.0% by 2021, largely due to manufacturing capacity expansions.

Service sector improves

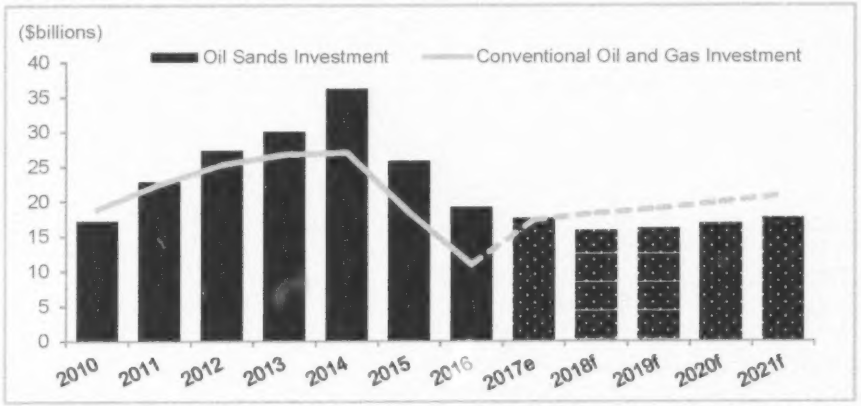
The service sector in Alberta makes up about 60% of the economy and fared better than the goods sector during the recession. It is expected to benefit from rising exports and growing business and consumer spending within Alberta. With oil and manufacturing output growing substantially and non-residential investment set to improve starting in 2019, rising spending within the business sector will provide a boost to professional, scientific and technical services and transportation and warehousing. Accommodation and food and other services in Alberta will also get a lift from increased business-related travel. Population and income growth will continue to drive demand for consumer services like finance and real estate and retail trade.

In addition to the demand for services within Alberta, service exports are forecast to continue recovering in 2018 and grow at a steady pace of around 3% over the medium term. Strengthening energy investment in the US and other jurisdictions particularly will increase the demand for services from Alberta's oil and gas sector. Overall, the service sector in Alberta is forecast to expand by 1.9% in 2018 and 2.3% over the medium term.

Prolonged nominal GDP recovery

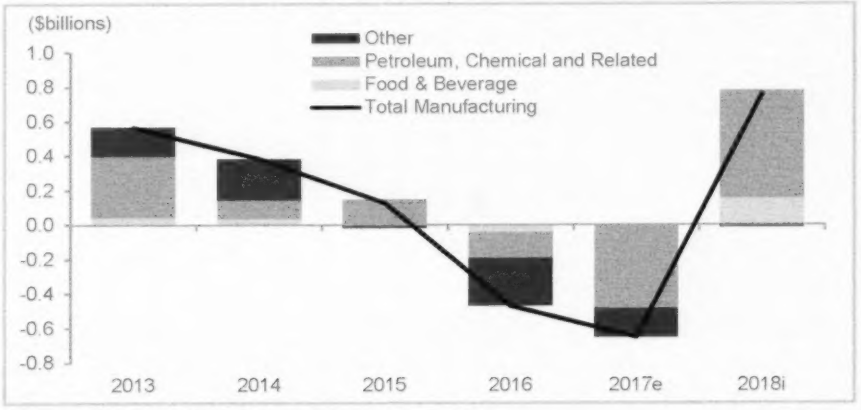
Despite the recovery in economic activity, the lingering effects of the recession and oil price decline are prolonging the recovery in nominal GDP, a broad measure of income. It is expected to grow annually by 5.2% between 2018 and 2021, but not return to

Chart 5: Conventional investment overtakes oil sands
Alberta Oil and Gas Investment



Sources: Statistics Canada and Alberta Treasury Board and Finance, e-estimate, f-forecast

Chart 6: Manufacturing investment to surge
Change in Alberta Manufacturing Investment



Source: Statistics Canada, e-estimate, i-intentions

pre-recession levels until 2020. With oil prices still far below where they were in 2014, the volume of oil exports in 2019 is expected to be 40% higher than in 2014 but the dollar value 10% lower. Cost containment and a rebounding economy are bolstering corporate profits; however, with oil prices not expected to exceed US$63/ bbl, corporate profits will remain below 2014 levels over the next three years. This is in contrast to household earnings, which should exceed 2014 levels beginning this year.

Labour market renewal

Building on the momentum in the labour market from the second half of 2017, employment growth is expected to accelerate in 2018 (Chart 7). In the last three months of 2017, employment increased sharply, marking a full recovery of jobs lost during the recession. This improvement was due to increases in full-time and private sector positions which are expected to extend into this year. Alongside steady growth in the service sector, solid conventional oil and gas activity and additional capacity in the manufacturing sector will boost job gains in the goods sector and support employment growth of 2.0% in 2018. The unemployment rate is forecast to average 6.8%.

Solid employment growth is expected throughout the forecast period as goods-producing industries continue to recover jobs and non-residential investment picks up. Employment growth is expected to average 1.7% by 2021. However, given the depth of the recession and the prolonged recovery, the unemployment rate will not move near pre-recession rates until 2021, when it is forecast to average 5.3%.

Continued improvement in the labour market, especially in the high-paying goods sector, will bolster earnings. With more full-time employment and hours worked, average weekly earnings (AWE) are forecast to expand by 2.4% in 2018 and around 3% annually between 2019 and 2021. This will support primary household income growth of 4.5% in 2018 and lift household income above the pre-recession level. Growth in primary household income is forecast to pickup to almost 5% by 2021.

Population growth picks up

Alberta's population is set to grow at a faster pace as the effects of the recession continue to fade. After two years of net outflows, interprovincial migration was again positive in the third quarter of 2017. Net inflows of 2,000 interprovincial migrants are expected in 2018, as improving economic conditions and affordable housing encourage more Alberta residents to stay in the province. Continued strong natural increase and solid immigration into the province are expected to support population growth of 1.4% in 2018, above the national increase of around 1%.

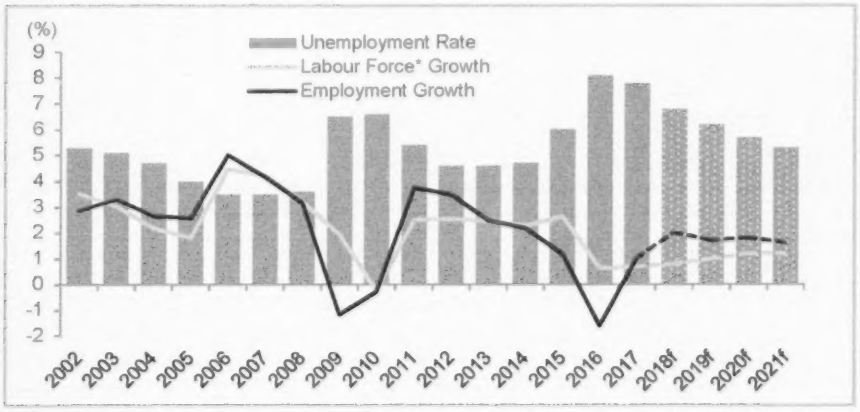
Immigration into Alberta is expected to rise to almost 41,000 by 2021 as the Federal Government raises the national target for immigration. As Alberta's economy continues to strengthen, net interprovincial migration is forecast to pick up gradually to 8,000 by 2021, boosting population growth to 1.6%.

Solid household spending

Following a surge in 2017, Albertans are expected to keep spending in 2018 and over the medium term. The increase is being driven by rising employment, wages and population. In 2018, real consumer spending (adjusted for inflation) is forecast to grow a solid 2.9%. Spending is expected to shift more to services and non-durable goods. With inflation expected to remain stable at around 2%, real household consumption is expected to grow by around 3% per year over the forecast, making a strong contribution to overall economic growth.

On the housing side, elevated inventories, higher interest rates and tighter mortgage rules are expected to keep housing starts contained this year at around 30,000. However, construction that began in 2017 will continue into 2018, which will support almost 9% growth in real residential investment. Alberta's more affordable housing market and a net inflow of over 42,000 people by 2021 are forecast to drive up residential building activity over the next four years. Housing starts are expected to hit 35,200 by 2021, while steady renovation spending is expected to bolster residential expenditures.

Chart 7: Unemployment rate easing
Alberta Labour Market Indicators



Sources: Statistics Canada and Alberta Treasury Board and Finance, f-forecast
* The number of people working or looking for work.

Risks to the Economic Outlook

- A faster increase in US shale production and weaker compliance to OPEC-led supply cuts could limit the recovery in prices.
- With oil production outstripping pipeline capacity starting this year, prolonged market access issues could lead to a wider differential, weighing on incomes and investment.
- In Canada, highly indebted households remain vulnerable to a faster-than-expected increase in interest rates.
- The threat of protectionist trade policies, such as those related to the NAFTA negotiations, is a key risk to the trade outlook.

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